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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1966

No. 417

LOUIS A. KLITZNER and ISABEL S. KLITZNER,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

HARRY F. LESHNOWER and RUTH S. LESHNOWER,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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To the Honorable, The Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioners herein pray that a Writ of Certiorari issue to review the Judgment of the United States Court of

Appeals for the Sixth Circuit entered in the above appeals on April 1, 1966.

OPINIONS BELOW

The opinion of the Court of Appeals for the Sixth Circuit as printed in the Appendix hereto at Pages 1a-4a, is per curiam, unpublished, and was entered April 1, 1966, affirming a memorandum decision of The Tax Court of the United States filed October 6, 1964, also printed in the Record before the Sixth Circuit at Pages R. 262a-R. 297a as officially reported in 23 T.C.M. 1601

Petition for Rehearing was seasonably filed and the order of the Court of Appeals dated May 6, 1966, denying the petition is printed in the Appendix at Page 4a.

JURISDICTION

Jurisdiction of this Honorable Court is invoked under 28 U.S.C., Section 1254(1) and 28 U.S.C., Section 2101. The Judgment of the Court of Appeals (1a) was entered on April 1, 1966. The order denying the petition to rehear (13a) was entered on May 6, 1966.

QUESTIONS PRESENTED FOR REVIEW

First Question

Is a conclusion of law that the entire consideration paid for a joint covenant, limiting and restricting competition, accompanying the sale of partnership interests in a going business, results in ordinary income to the recipients under Section 61(a), Internal Revenue Code of 1954, supported by an ultimate finding that the covenant was "separately" bargained for and was "severable" from the other assets of the going business.

Second Question

Is the refusal of the Trial Court to consider undisputed and probative evidence illuminating the substance underlying a formal contract an erroneous limitation imposed upon, and an erroneous deprivation of, the Petitioners' "substantial rights."

STATUTES INVOLVED

(1) 1954 Code, Subtitle A, Ch. 1 B, Part I, Definition of Gross Income, Adjusted Gross Income and Taxable Income.

"Section 61, (a) General Definition. Except as otherwise provided in the subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions and similar items:

* * *

(3) Gains derived from dealings in property; . . ."

(2) 1954 Code, Subtitle A, Ch. 1 K, Part II C, Transfer of Interests in a Partnership.

"Section 741. Recognition and Character of Gain or Loss on Sale or Exchange.

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partners. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in Section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value)."

(3) 1954 Code, Subtitle A, Ch. 1 B, Part VI, Itemized Deductions for Individuals and Corporations.

"Section 162, (a) In General. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including,

(1) A reasonable allowance for salaries or other compensation for personal services actually rendered;

* * *

Section 167. (a) General Rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)

(1) of property used in the trade or business, or

(2) of property held for the production of income."

(4) 1954 Code, Subtitle A, Ch. 1 P, Part III, General Rules for Determining Capital Gains and Losses.

"Section 1221. Capital Asset Defined.

For purposes of this Subtitle the term 'Capital Asset' means property held by the taxpayer (whether or not connected with his trade or business) but does not include,

(1) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;"

* * *

STATEMENT OF THE CASE

The Tax Court made the following ultimate finding (R. 288a):

> "The covenant not to compete executed by Petitioners and National Linen Service Corporation on June 2, 1958, was separately bargained for and was severable from the other assets of American."

It made the following conclusions of law (R. 295a):

> "Petitioners have failed to establish that the **covenant not to compete** executed . . . on June 2, 1958, is **anything other than what it purports to be**. It is abundantly clear to us that the **covenant** was **separately** bargained for in an arm's length transaction, and that it is **severable** from the other assets of American which were transferred to National and we therefore hold that the considerations received by Petitioners thereunder during the years in issue constitutes ordinary income to them pursuant to Section 61(a) of the Code." (Emphasis supplied).

The Court of Appeals for the Sixth Circuit after "carefully" reviewing the findings of fact in the case rested its affirmance upon the following recital (Appendix, Page 3a, Opinion):

> "The undisputed facts in this case clearly showed that the purchase of this linen supply business was the result of hard bargaining wherein Petitioners were capably and effectively represented by persons fully familiar with the tax consequences of the negotiations. Early in the negotiations National made it clear that it would insist upon the execution of **covenants** (*sic*) not to compete by the two principals involved here. This record leaves no doubt that the **covenants** (*sic*) not to compete had real economic value for the purchaser."
>
> "Ultimately the price for these **covenants** (*sic*) was set at $375,000.00 payable to Klitzner and Leshnower **in accordance with their respective interests** over a period of ten years. The consideration for the **covenants** (*sic*)

not to compete was recited in a separate contract by which those **covenants** (*sic*) were made binding. The Tax Court found these facts and many others **to support its ultimate decision** in a lengthy set of findings of fact which we have reviewed carefully and which we cannot declare to be clearly erroneous, *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960)." (Emphasis supplied).

Demonstrating its approval of the legal criteria of "separate" and "severable" applied by the Tax Court, the Court of Appeals quoted from its decision in *Montesi* v. *Commissioner*, 340 F.2d 97 (6th Cir. 1965) (Appendix, pp. 3a-4a, Opinion):

> "In a recent decision in this Court the factual situation was closely parallel to the facts with which we deal here. In determining that compensation **for several covenants not to compete** should be held ordinary income for tax purposes, this Court said:
>
> 'This record demonstrates that there was arm's length bargaining; that the Montesi's were capably represented and were under no economic or other pressure to accept contractual terms which placed them at an unfair position from a tax point of view; **that the contracts not to compete** were of significant value to National Tea, **and that the parties set a separate valuation on them.** This record taken as a whole does not convince us (as it did not convince The Tax Court) that the $250,000 value which the parties themselves set on these contracts was unrealistic. . .'
>
> **With only the names and amounts changed, this same statement is applicable to the present case.**" (Emphasis supplied).

Messrs. Klitzner and Leshnower, Petitioners in this case, were partners who sold their partnership interests in their linen supply business, known as American Linen Service Company, as a going concern—including its good will—to the National Linen Service Corporation with **a single accompanying joint covenant** entitled a "Restrictive

Covenant" by the document but variously referred to as a covenant not to compete by the Trial Court (and as covenant(s) not to compete by the Appellate Court) being valued at $375,000.00 by the parties and payable to the Petitioners in installments of $37,500.00 over 10 years **divisible between them in accordance with their sole discretion.** These are undisputed facts.

The Petitioners consistently reported the payments received under the covenant in proportion to their respective ownership interests in the going business sold and claimed capital gain pursuant to the provisions of Sections 61(a), 741 and 1221 of the Internal Revenue Code of 1954.

The Commissioner of Internal Revenue held that the entire consideration received under the covenant was ordinary income to the Petitioners.

Petitioners made a Motion for Entry of Decision (R. 251a-258a) which was replied to by the Commissioner (R. 259a-261a) and was denied by the Tax Court.

The Tax Court upon the trial received undisputed proof from the Petitioners and the Respondent which supported the following findings of fact:

(a) A minimum good will value of $375,000.00 out of a gross consideration of $1,084,019.45. (R. 194a, 195a, 196a; R. 248a, Ex. 38 and 39; R. 249a, Ex. 40).

(b) The purchaser's books reflected the purchaser's **unilateral** allocations of the purchase price to assets a less value to good will than the $115,000.00 it had previously **and also unilaterally** allocated to good will in its formal offer to purchase dated May 26, 1958. (R. 88a-89a, Jt. Ex. 23-W; R. 220a, R. 303a).

(c) The Petitioners received and reported the payments consistently in the exact ratio of their proprietary interests in the business rather than in accordance with any determination by the purchaser of the reasonable value of their joint or several services,

affirmatively or negatively rendered. (R. 113a, Jt. Ex. 31-EE, R. 165a).

(d) Prior to obtaining the Petitioners' covenant, the purchaser had followed a practice of carrying all such covenants on its books as capital assets. (R. 243a, 285a)."

The Petitioners upon these facts made a Motion for Entry of Decision (R. 251a-258a) which was opposed by the Commissioner (R. 259a-261a) who relied upon the "separate" and "severable" tests of the cases of *Clarence C. Hamlin Trust*, 19 T.C. 718 (1953), aff'd 209 F.2d 761 (10th Cir. 1954); *Emmette L. Barran*, 39 T.C. 515 (1962) on appeal 5th Cir. March 4, 1963; *Charles W. Balthrope*, T.C. Memo 1964-31 and asserting the Commissioner's position that **"all cases turn on the question of whether the covenant was the subject of separate consideration and monetary evaluation by the parties.** *Estate of Mildred K. Hyde*, 42 BTA 738 (1940); *Rodney B. Horton*, 13 T.C. 143 (1949), app. dismissed 180 F.2d 354 (10th Cir. 1950)." (Emphasis supplied).

The Tax Court overruled Petitioners' motion and failed to make any specific findings in respect thereto sustaining the Commissioner's determination and position as to the "separate" and "severable" standards to be applied for the determination of the tax consequences of the transaction. In doing so, the Tax Court rejected the materiality of the offer of proof made by Petitioners of a prior examination of the Petitioners' returns by the Commissioner of Internal Revenue under Sections 741 and 751 of the Internal Revenue Code of 1954 for the year 1958, the year in which the transaction of sale occurred, which was made by Petitioners to explain and illuminate their understanding of the transaction and their later consistent tax treatment thereof; although the Tax Court had accepted as probative evidence the **testimony of the purchaser as to its** understanding of, and treatment of, the covenant, all

of which upon undisputed evidence was clearly inconsistent with the understanding of, and the tax treatment of, the transaction by the purchaser and the Commissioner of Internal Revenue in 1958 which was the year of sale. Two of the most significant inconsistencies being that the highest average inventory of the partnership was approximately $20,000.00 (R. 51a, Jt. Exs. 5-E, 6-F, 7-G, 8-H and 9-I), whereas the purchaser had used **a new linen inventory of $86,053.00 and had added another $240,000.00 for a used inventory or a total of $326,053.00 for inventory.** (R. 51a-52a, R. 231a, 232a-233a, 303a—Jt. Ex. JJ).

Petitioner appealed the case to the Court of Appeals for the Sixth Circuit seeking reversal upon questions of fact and law, and rulings upon exclusions and inclusions of evidence, asserting error in the Trial Court's consideration of, and rulings upon, evidence and in its findings of evidentiary and ultimate facts and conclusion of law.

The Court of Appeals for the Sixth Circuit affirmed per curiam.

REASONS FOR GRANTING THE WRIT

Petitioners contend that the Tax Court and the Sixth Circuit Court of Appeals have applied erroneous court-evolved misconceptions of the legal standards and rules approved by this Honorable Court for determining the "economic reality" and "tax consequences" of a covenant transaction, and thereby the Petitioners have been deprived of "substantial rights" and denied "substantial justice" as contemplated by *Rule 61, Fed. R. Civ. P.*

Petitioners further contend that the erroneous conclusions of the trial court and reviewing appellate court in this case not only are in conflict with the legal standards and rules for decision approved by this Honorable Court

but are also in conflict with the legal standards and rules for decision followed by other courts of appeal. Consequently, the supervision of, and guidance of, this Honorable Court is sorely needed to correct errors of procedure and eliminate diversities in the administration of tax law.

Unless the erroneous, undeterminative and conflicting legal standards of the Tax Court and the Court of Appeals for the Sixth Circuit are corrected by this Honorable Court "uniformity in taxation" will mean "uniformity in the tax consequences of the form of a transaction irrespective of all matter of substance" rather than, "uniformity in the application of the law to the substance of a transaction irrespective of its form and the tax consequences thereof."

There are conflicts, within and between, the trial and reviewing appellate courts, which are dramatically illustrated in commentaries searching for practical guidance and sound criteria for decision in the ever-growing body of case law.[1]

We hazard criticism of the text writers who suggest that in covenant cases "tax consequences" may be the subject of negotiations between the parties to a contract, and the subject of variations of their contract values irrespective of the realities of the resulting allocations in the context of the substance underlying the transaction. This line of reasoning is a patent encouragement to the development of tax schemes and devices.

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1. Taylor, "Covenants Not to Compete, Consulting Arrangements, Adjustments to Purchase Price," New York Univ., 12th Inst. on Fed. Taxation (1954), pp. 1047 to 1065; Barnet, "Covenants Not to Compete: Their Effects upon the Covenantor and Covenantee," New York Univ., 18th Inst. on Fed. Taxation (1960), pp. 861 to 878; Armstrong, "Tax Valuation of Good Will," Univ. So. Calif. Law School, Tax Inst. (1951), pp. 466-467; Wolfen, "Tax Effects of Covenants Not to Compete;" Univ. So. Calif. Law School, Tax Inst. (1960), pp. 667-691; Mertens, Treatise on Law of Federal Income Taxation, Vol. 3-B, Sec. 22.33.

Covenants not to compete as dealt with by the courts prior to 1955 apparently fell into the legally recognized categories of "naked," "third party," and "sellers" covenants upon legal considerations of public policy. An example of a "naked" covenant is drawn from the case of *News Leader Co.*, 18 B.T.A. 1212 (1930), acq. IX-2 CB 44. Although considerations of public policy would ordinarily impute illegality to a "naked" covenant, the decision of the then Board of Tax Appeals acquiesced in by the Commissioner, approved treatment of the right to compete covered by a covenant as a "property right" and the receipts therefrom or payments therefor as of a capital nature.

Examples of a "Sellers" covenant are found in the case of *Rodney B. Horton*, 13 T.C. 143 (1949), nonacq., 1949-2 CA 4, **later acquiesced in result only** 1959-2 CB 5, with nolle prosse of appeal to the 10th Circuit, 180 F.2d 354; and in the case of *Toledo Newspaper Co.*, 2 T.C. 794 (1943), acq., 1944 CB 23 which arose in the Sixth Circuit but was not appealed and was the other side of the transaction in *Toledo Blade Co.* v. *Commissioner*, 11 T.C. 1079, aff'd 180 F.2d 357 (6th Cir. 1950) cert. denied 340 U.S. 811.

Examples of "third party" covenants were found in the cases of *Cox* v. *Helvering*, 71 F.2d 987 (D.C. Cir. 1934); *Salvage* v. *Commissioner*, 76 F.2d 112 (2d Cir. 1935) aff'd 297 U.S. 102; *Estate of Beals* v. *Commissioner*, 82 F.2d 268 (2d Cir. 1936); *Commissioner* v. *Gazette Telegraph Co.*, 209 F.2d 926 (10th Cir. 1954).

In the *Horton* case, supra, the court relied upon *Estate of Mildred K. Hyde*, 42 B.T.A. 738 (1940) a "third" party covenant case holding that the covenant accompanying the sale by the proprietor of a professional business was allocable as to value in "dealings in property" as they are realistically related to the transferable good will of the

business or to the personal characteristics or qualifications of the owner. In the *Toledo Newspaper Co.*, case, supra, the "seller" covenant accompanying the sale by the corporate proprietor of assets and good will was also held to result in capital gain.

It is interesting to note the effects of some of the above cases in the jurisdictions of the Courts of Appeal for the Second, Fifth, Sixth and Tenth and in the jurisdictions of the Courts of Appeal for the Third, Fourth, Seventh and Ninth Circuits.

In *Horton*, supra, "separate" and "severable" payments over a 5 year period were allocated between good will and the covenant not to compete. In *Toledo Newspaper Co.*, and *Toledo Blade Co.*, supra, the "separate" and "severable" payments over a 10 year period were treated as a dealing in property and capital in nature.

"Third Party" covenants were considered ordinary income by the courts in *Beal's Estate* v. *Commissioner*, 31 B.T.A. 966, aff'd 82 F.2d 268 (2d Cir. 1936).

Cox v. *Helvering*, 71 F.2d 987 (D. C. Cir. 1934), and *Salvage* v. *Commissioner*, 76 F.2d 112 (2d Cir. 1935), aff'd 297 U.S. 106, **relied upon by** the Commissioner of Internal Revenue, were distinguished by the trial court in the *Toledo Newspaper Co.*, case, supra, as being "third" party covenants of stockholders, officers or employees **who have sold no capital asset** but have simply received a sum of money for agreeing not to compete and thereby were related to the personal characteristics or qualifications of the covenantors constituting ordinary income.

Accordingly, it would appear that between the 1944 acquiescence in the *Toledo Newspaper Co.*, case, supra, and the 1949 nonacquiescence and the 1959 acquiescence of

the Commissioner in the *Horton* case, supra, no diversities in the administration of the tax laws by the Commissioner and in the courts had occurred insofar as the legal standards which were to be applied to "naked," "seller" and "third party" covenants as late as 1955 and that diversities did not occur until after the 1959 acquiescence in "result only" in the *Horton* case, supra.

The diversities were engendered in the period coterminous with the 1959-1960 period between this Honorable Court's decision in *Commissioner* v. *Hansen*, 360 U.S. 446 (1959) clarifying the case of *Commissioner* v. *Court Holding Company*, 324 U.S. 331 (1945); and the decision in *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960).

The reasons for granting this writ rest upon the rules for decision established by this Honorable Court in the *Court Holding Company*, *Hansen* and *Duberstein* cases, supra, and the apparent failure of the Second, Fifth, Sixth and Tenth Circuits to observe these rules for decision and the continued adherence of the Court of Appeals for the Sixth Circuit to the obsolete and erroneous legal standards of those circuits in conflict with decisions of the Third, Fourth, Seventh and Ninth Circuits which are in harmony with the above-cited decisions of this Honorable Court.

To dramatically illustrate the conflicts now existing which justify this writ, we have drawn upon the cases of the opposing Circuits.

First, we urge that the rules for decision laid down by this Honorable Court in the *Court Holding Company*, *Hansen* and *Duberstein* cases, supra, were: (a) the incidence of taxation depends upon substance rather than form; and (b) the triers of fact are responsible for passing upon the "totality" of the facts of each case. To these rules a third may now be added from the case of *United*

Finance and Thrift v. *Commissioner*, 282 F.2d 919 (C.A. 4 1960), cert. denied 366 U.S. 902, affirming 31 T.C. 278, acq., 1959-1 CB 5, in which the value of a "separate" and "severable" covenant executed by "third parties" was broken down within the covenant between transferable good will and the personal characteristics and qualifications of the covenantors upon the authority of *Cohan* v. *Commissioner*, 39 F.2d 540 (2d Cir. 1930) against the opposing contentions of the Commissioner that the covenant was related to good will and not deductible and the taxpayers' contention that the separate and severable covenant was related to personal qualifications or characteristics and fully deductible. The additional rule is: (c) In tax cases the trial courts should sua sponte or, at the instance of a contracting party or the Commissioner, look to the substance rather than the form of the transaction to determine whether the parties' contract has economic reality as it relates to good will or personal characteristics and qualifications. By trial and appellate court observance of these three (3) legal standards, the "economic reality" of a transaction may be soundly tested for the incidence of taxation.

It has been noted that the Court of Appeals for the Sixth Circuit affirmed the trial court upon its ultimate finding that the covenant payments were "separate" and "severable." These tests were established in the Tenth Circuit in the cases of *Hamlin's Trust* v. *Commissioner*, 209 F.2d 761 (10th Cir. 1954) and its companion case of *Commissioner* v. *Gazette Telegraph Co.*, 209 F.2d 926 (10th Cir. 1954). The Second Circuit thereafter accepted the two (2) tests and placed a limitation upon the "substantial rights" of a contracting party (but not upon the Commissioner of Internal Revenue) under the burden of proof rule established by this Honorable Court in *Helvering* v.

Taylor, 293 U.S. 507 (1934) by requiring "strong proof" of taxpayers as to why the "separate" and "severable" values appearing in the formal contract should not be followed in its case of *Ullman* v. *Commissioner*, 264 F.2d 305 (2d Cir. 1959). The "separate," "severable" and "strong proof" criteria of the Tenth and Second Circuits have been accepted, followed and defended by the Fifth Circuit in *Barran* v. *Commissioner*, 334 F.2d 58 (5th Cir. 1964), and *Balthrope* v. *Commissioner* ..... F.2d ..... (5th Cir. 1966). These criteria have also been accepted and followed by the Sixth Circuit in *Montesi* v. *Commissioner*, 340 F.2d 97 (6th Cir. 1965) and in these Petitioners' case, but the "separate" and "severable" criteria were **expressly rejected by the Ninth Circuit with criticism supported by** *Mertens, Treatise on Law of Federal Income Taxation*, Vol. 3-B, Sec. 22.33 in the cases of *Schulz* v. *Commissioner*, 294 F.2d 52 (9th Cir. 1961) and *Annabelle Candy Co.* v. *Commissioner*, 314 F.2d 1 (9th Cir. 1962), holding that the "separate" and "severable" tests were erroneous as a matter of law.

The Seventh Circuit in *Wilson Athletic Goods Mfg. Co.* v. *Commissioner*, 222 F.2d 355 (7th Cir. 1955), followed *Court Holding Company*, supra, in a manner harmonious with the *Hansen, Duberstein*, and *United Finance and Thrift Corporation* criteria for decision as set forth above holding that the trial court acted properly, sua sponte, **and upon all the evidence** to specifically allocate a "separate" and "severable" value to a covenant out of a gross consideration paid for a going business where such had not been done by the parties in their formal contract.

The Third Circuit accepted the Ninth Circuit's *Schulz* and *Annabelle Candy Company* cases, supra, to sustain the Tax Court's sua sponte separation of a "separate" and "severable" value which had been assigned by the con-

tracting parties' contract to a covenant into a value related to "good will" and a value related to the "covenant" after a consideration of **all the facts in the case.** *Levine* v. *Commissioner,* 324 F.2d 298 (3rd Cir. 1963), affirming *Max Levine,* 21 T.C.M. 363 (1962), in which the Tax Court relied upon its earlier case of *Rodney B. Horton,* supra, for going behind the assigned covenant value.

In summary, the Petitioners urge that the rules for decision of the Third, Fourth, Seventh and Ninth Circuits **are in harmony with the rules of decision of this Honorable Court** in the *Court Holding Company, Hansen, Duberstein* and *Taylor* cases, supra; and that the rules for decision of the Second, Fifth, Sixth and Tenth Circuits are obsolete and erroneous and are being applied to the deprivation of the substantial rights of litigants in tax cases arising in those jurisdictions, creating diversities in the administration of tax law. Petitioners urged that the position of the Commissioner that "separate" and "severable" standards are controlling of the tax consequences of the cases and that the opinion of the Court of Appeals for the Sixth Circuit that the evidentiary findings of the Trial Court supported these legal standards of "separate" and "severable" and were not "clearly erroneous" resulted in a limited trial as well as a limited review because the trial court and the appellate court should have considered the totality of the facts of the case and made determinative findings as to the economic reality of the "sellers" covenant given by Petitioners as it related to the good will of the business sold or to the personal characteristics or qualifications of the Petitioners. Cf. *Masquelettes Estate* v. *Commissioner,* 239 F.2d 322 (5th Cir. 1956), Rev. Rul. 60-301, 1960-2 Cum. Bull. 15.

Failure to do so was contrary to the doctrine of the *Court Holding Company, Hansen, Duberstein, United Fi-*

nance and Thrift and *Taylor* cases and deprived Petitioners of "substantial rights."

In summary, the reasons for granting the writ are: The Commissioner relied upon the standards of "separate" and "severable" in this case as the standards **upon which all the cases turn.** (R. 259a). The Tax Court accepted these standards in its ultimate finding (R. 288a) and the Sixth Circuit affirmed the standards (Opinion, pp. 1a-2a), whereas, the Ninth Circuit has held the Commissioner's position as to these standards and the Tax Court's placing emphasis upon them to be an erroneous theory of law in *Annabelle Candy Company,* supra, creating a conflict as between the Circuits and confusion as to the correct standards to be applied within and among the Circuits.

ARGUMENT

First Question

No attempt was made by the Trial Court to go behind the form of the transaction after its finding that the covenant executed by Petitioners was **separately** bargained for and was **severable from the other assets of American.** (R. 288a). It would have been more appropriate if the Trial Court had found that it was severable from the partnership interests in American which were the real subject of the sale because the Court also commented in its general and conclusory opinion (R. 291a)

> ". . . although it is true that under the offer and acceptance executed May 26, 1958, **they sold their partnership interests to National, we are unable to find support in the record for their conclusion that the payments in question should be characterized as payment therefor.**"
>
> (Emphasis supplied).

The Trial Court with this general and conclusory statement effectively foreclosed its consideration of the **totality of the facts of the case** upon a record which contained the following facts relied upon by the Petitioners:

(a) Undisputed evidence of P. K. Seidman, an outstanding Certified Public Accountant and partner in the internationally known firm of Seidman & Seidman, to the effect that good will was a substantial factor in the negotiations; and his undisputed testimony as to the value of the tangible assets, income and acceptable rates of return on investment **which supported a minimum good will value of $375,000.00 out of a total consideration of $1,084,019.45 received** (R. 194a, 195a 198a; R. 248a, Ex. 38, 39; R. 249a, Ex. 40), all of which was material and competent evidence under *A R M 34, 2 CB 31; Rev. Rul. 59-60, 1959-1 CB 237, Rev. Rul. 65-192, 1965-2 Cum. Bull. 259, and Plaut* v. *Smith,* (2d Cir. 1951) (C.A. 2, 1951) 51-1 USTC 9254.

(b) Undisputed evidence of the Respondent introduced in the form of Exhibit JJ (R. 303a) which showed the Purchaser's record of the sale made on June 1, 1958, immediately after the execution of the formal sales contract on May 26, 1958 (R. 88a-94a) and recorded the covenant as a "**Restrictive Agreement 10 years from June 1, 1958, not deductible for income tax**" and also that the Purchaser's book entries reflected a less good will value than the $115,000.00 it had unilaterally assigned to good will in its formal offer to purchase dated May 26, 1958, identified as Jt. Ex. 23-W. (R. 88a-89a, Jt. Ex. 23-W; R. 220a; R. 303a).

(c) Undisputed evidence of the Petitioners that they jointly received and divided the payments in the same ratio in which they owned the partnership interests sold, rather than in accordance with any evaluation of their several personal services, negatively or affirmatively rendered, by the Purchaser. (R. 113a, Jt. Ex. 31-EE; R. 165a).

The Tax Court made 53 specific findings which are not disputed and which support its ultimate finding of a "separate" and "severable" covenant, but which fail to support any valid conclusion of law that the payments received by the Petitioners should be taxable under Section 61(a) of the Internal Revenue Code of 1954 as either "compensation for services" or as "gains derived from dealings in property." The conclusion reached that the covenant was compensation for services and ordinary income was an argumentative and whimsical trial of the tax liability rather than a legal conclusion realistically directed by findings of determinative facts from all of the facts of the case.

In the sale of linen supply businesses as going concerns by the individual or corporate proprietors or by partners which is accompanied by a "sellers" covenant, limiting or restricting competition, such covenants were, until 1958, the year of the Petitioners' sale, consistently held to represent gain derived from dealings in property rather than in compensation for personal services under Section 61(a) of the Code. Cf. *Aaron Michaels,* 12 T.C. 17 (1949), acq. 1949-1 Cum. Bull. 3; *Joseph and Marjorie Faulkner,* T.C. Memo 1956-39, filed 2/21/56, 15 T.C.M. 175; *Harold J. Burke,* 18 T.C. 77 (1952); *Toledo Newspaper Co.,* 2 T.C. 794 (1943), acq. 1944 Cum. Bull. 28; *Toledo Blade Co.* v. *Commissioner,* 11 T.C. 1079, aff'd 180 F.2d (6th Cir. 1950), cert. den. 340 U.S. 811.

Conversely, in the sale of stock of a corporate linen service business by the stockholders accompanied by a "third" party or stockholders covenant, limiting or restricting competition, the covenant payments were, until 1958, the year following the Petitioners' sale, held to result in deductible expense over the period of the covenant. *Andrew Newman, Inc.,* 16 T.C.M. 1018 (1957). This case

was grounded upon the case of *Richard Ullman*, 29 T.C. 129 (1957), aff'd *David H. Ullman* v. *Commissioner*, 264 F.2d 305 (2d Cir. 1959), which dealt with a "third" party or stockholder covenant.

The opposite results were based upon clear distinctions recognized by the trial courts as to the dominant transactions, i.e., (1) a sale of good will and capital assets; or (2) elimination of personal characteristics and qualification from competition.

This was the legal atmosphere in which the Petitioners negotiated with their purchaser and arrived at the terms of their contract and their covenant in May, 1958.

The only understandable tax consequence of the transaction in 1958 was that the dominant transaction was the sale of a going business, including its good will as a going concern.

The case law supported capital treatment under Sections 741 and 1221 of the Internal Revenue Code of 1954, and Mr. P. K. Seidman, who was the Petitioners' representative at the bargaining table, a widely recognized and highly regarded accountant and attorney, testified (R. 186a):

> "Q. Now, Mr. Seidman, when was discussion of the restricted covenant had between you and the representative of National Linen?
>
> A. Quite early in the negotiations. I recall it was mentioned that National would want or expect to get a restrictive covenant agreement. I mentioned that I certainly had no objection to that if that was what they wanted. All we were concerned with was the sale of the partnership interests and the two corporations and that they could handle the transaction as they felt best for their own purposes since we were selling what we considered as capital assets

Q. Now, had you and your clients arrived at a price for this sale?

A. We had arrived at an overall price, yes, sir."

This was also the legal atmosphere which surrounded the execution of Joint Exhibit 23-W on May 26, 1958 (R. 88a-94a), as to which Mr. Seidman testified (R. 187a):

"Q. Well, now referring to that document, Joint Exhibit 23-W and particularly to the acceptance signed by your clients, did you have anything to do with the wording of that acceptance?

A. Yes, sir, I did.

Q. And what did you have to do with it?

A. The document was presented indicating a breakdown of the assets even though the recital at the beginning of the instrument indicated that it was a purchase of a partnership interest, and I advised my clients, as well as I did the representative of National Linen, that we would not sign any such agreement unless we were permitted to take a complete disclaimer of the enumeration and listing of the value or even the enumeration of the type of assets that they were acquiring."

This was also the legal atmosphere existing when **the purchaser entered the covenant payments on its books as "not deductible for income tax"** as shown by its Exhibit JJ. (R. 303a). Is it reasonable for any court to conclude on a total record showing no agreement to accept any other tax consequences by the seller or purchaser, that the purchaser, also capably represented, was clairvoyant enough to change its 1958 acceptance of a capital transaction in anticipation that the "separate" and "severable" and "strong proof" standards which did not become existent until 1959 and afterwards would be applied in 1964 and 1966 to "sellers" covenants executed in 1958 in a manner allowing the "de-

ductibility of the payments for income tax", contrary to the purchasers' clear-cut understanding as reflected on its books? Is it reasonable for any trial court to conclude at some later date that the parties' understanding of the tax consequences of the transaction recorded in 1958 was the opposite of their acts and conduct because of the form of the transaction rather than its substance? Such conclusions are patently unreal when the total record shows that the tax results to the parties were antithetical and that no agreement was reached as to tax consequences.

It cannot be disputed that the Petitioners assumed and the Purchaser, by its recorded book entries, accepted the tax consequences of the transaction as a capital transaction in 1958. The Trial Court obviously construed the rule of the *Duberstein* case, supra, to be a directive to the appellate courts as to the scope of review, but not as a directive to the trial courts to consider the "totality of the facts of each case" and make specific findings in order that the reviewing court may determine the legal standards it has applied.

The reviewing court having accepted the erroneous and obsolete "separate" and "severable" and "strong proof" legal standards of the Second, Fifth and Tenth Circuits in its *Montesi* case, supra, also construed its duty under *Duberstein*, supra, to be only to determine whether the evidence supporting those erroneous and obsolete standards was "not clearly erroneous," thus **elevating form above substance** contrary to the *Court Holding Company* and *Hansen* cases, supra, and failed to find in *Duberstein* any directive to the Trial Courts to consider the totality of the facts of each case.

The unenlightened applications by the courts of the "separate" and "severable" and "strong proof" tests to covenants not to compete have served only to undermine and destroy the rule of substance over form. This result is

cogently exemplified in the case of *Rogers* v. *United States*, 290 F.2d 501 (9th Cir. 1961), where the court begins its opinion with this statement: "The taxpayers probably have been maneuvered by their purchaser into a big tax disadvantage." That court went on to hold that the trial court could properly refuse to look beyond the agreement in which the parties set out a specific amount for a restrictive covenant and to treat the amount as ordinary income. This is the *reductio ad absurdum* of the principles embodied in the "separate" and "severable" tests. Evidently, the taxpayer may not even explain his position.

The Trial Court in the instant case apparently shared the view of the court in *Rogers* v. *United States*, supra. In spite of the well-settled and judicially noticeable rule that the burden of proof is on the taxpayer, both as to risk of non-persuasion and risk of non-production of evidence, the Tax Court, and the Sixth Circuit Court of Appeals have now ruled that the trial court may foreclose the production of evidence as to an issue which is relevant and material, even critical, and then at the close of the trial hold that the taxpayer has failed to meet his burden of proof.

As was aptly stated by a very able judge, "the one sure way to do injustice in such cases is to allow nothing whatever upon the excuse that we cannot tell how much to allow." *Commissioner* v. *Maresi*, 156 F.2d 929, at 934 (1946).

A decision such as that in *Rogers* v. *United States*, supra, and the instant case, effectually elevates to the status of a conclusive presumption of law the proposition, stated as dictum in the *Barran* case, supra, that where the parties bargain at arm's length over the terminology to be used in expressing an agreement not to compete and conclude with a specific agreement including a separately stated consideration not to compete, this amounts to something like a

bargain between them that the seller, covenantor, will assume the unfavorable tax consequences flowing from the consideration and the purchaser will get the corresponding tax benefits. This proposition has no real foundation in the federal statutes or regulations. There is, or should be, nothing magical about the covenant not to compete. The crucial question is whether, under all the facts and circumstances, the covenant represents a surrender of income by the covenantor, either wholly or partly, or whether it represents wholly or partly a payment for good will.

Between the date the covenant was contracted for on May 26, 1958, and the date of the trial in the Tax Court on February 25, 1966, conflicts had developed among the Circuits and the law of the Sixth Circuit had radically changed from its decisions in *Toledo Blade Co.*, supra, and *Commissioner* v. *Shapiro,* 125 F.2d 532 (6th Cir. 1942); which latter case held that the sale of partnership interests in a going concern resulted in capital gain in harmony with Section 741 of the Internal Revenue Code of 1954.

We respectfully urge that diversities in the administration of tax law exist in the decisions of the Sixth Circuit as well as between the decisions of the Second, Fifth, Sixth and Tenth Circuits and the Third, Fourth, Seventh and Ninth Circuits which require the supervision and guidance of this Honorable Court because these diversities are contrary to the mandate of the rules of decision pronounced by this Court in its *Court Holding Company, Hansen* and *Duberstein* cases.

Second Question

This Honorable Court established the rule for the burden of proof in tax litigation in *Helvering* v. *Taylor,* 293 U.S. 507 (1934). The rule for decision now established for the trial courts in *Duberstein,* supra, obligates them to

consider the totality of the facts of each case and to make specific findings thereon. Under this Honorable Court's *Court Holding Company* and *Hansen* cases, supra, it has been established that the totality of the facts of a case requires the triers of fact to embrace within the totality of the facts of a case evidence tendered or introduced to test the substance underlying the form of a transaction in order to arrive at a decision as to the tax consequences thereof.

In this case the Petitioners, in their reply brief and Petition for Rehearing (pp. 4a-12a) filed in the Court of Appeals for the Sixth Circuit, called that Court's attention to the failure of the Respondent to observe Sixth Circuit Rule 16(4)(b) and the Respondent's reliance upon the trial court's findings and general and conclusory opinion without supplying a "counter-statement of facts" pointing out insufficiencies or inaccuracies in the Petitioners' statement. Petitioners had urged the trial court in its Motion for Entry of Decision (R. 251a-258a) to consider facts which the Petitioners contended were determinative facts based upon undisputed evidence and contained within the totality of the facts of the case. It also urged the Appellate Court to consider certain determinative and undisputed facts. These facts were:

* * *

> "26. Mr. Klitzner and Mr. Leshnower were interested in selling the linen service business for a price and the negotiations engaged in by them were for the sale of their partnership interests in American Linen Service Supply Company and its related corporations, Textile Maintenance Corporation and American Rental Corporation, as a going concern for an overall figure of $1,200,000.00, the overall price was based upon a business doing approximately $60,000.00 a month

volume, a net profit of $100,000.00 per year, and other factors such as price schedules, selling schedules, customers lists, trade routes and purchase area. (R. 150a, 153a, 154a-157a, 163a-164a)

* * *

28. By May 19, 1958, an overall price had been arrived at for the sale of the partnership interests in the linen service business and the assets of the two corporations used by that business, said price being $1,085,000.00 and prior to that date National Linen Service Corporation had expressed its desire for a restrictive covenant agreement in the negotiations with Mr. Seidman who stated that he had no objections to that if that was what the purchaser wanted because the sellers were concerned with the sale of partnership interests and the two corporations and the purchasers could handle the transaction as they felt best for their own purposes since the sellers were selling what they considered capital assets. (R. 168a-169a, 175a, 184a-190a, 192a-194a, 198a-200a, 203a).

* * *

32. All documents were drafted by representatives of National Linen Service Corporation, the purchaser in the transaction and the only things which Mr. Seidman dealt with representing the sellers was the wording of the acceptance executed by Mr. Klitzner and Mr. Leshnower on the formal agreement dated May 26, 1958, which was a disclaimer of the enumeration of values as well as the listing of assets used by the purchaser. (R. 40a, 88a-94a, 187a, 220a-221a; Stip. Par. 16, Jt. Ex. 23-W).

* * *

38. Mr. Klitzner and Mr. Leshnower received the overall consideration of $1,084,019.15 from the sale in accordance with the following schedule prepared by Mr. Seidman:

American Linen Service Reconciliation of Sale

	Total	Linen	Textile	Rental
Bill of Sale—Cash	$ 695,563.36	$545,163.36	$100,400.00	$50,000.00
Adjustments—Cash				
Laundry Supplies	6,991.26	1,397.25	5,574.01	
Personalty Tax	270.27		270.27	
Passenger Cars	3,108.26			3,108.26
Accounts Receivable	3,086.00	3,086.00		
Total Cash Consideration	709,019.15	549,646.61	106,264.28	53,108.26
Covenant Agreement	375,000.00			
Total Consideration	1,084,019.15	549,646.61	106,264.28	53,108.26

(R. 188a, 189a, 193a-194a, 248a; Pet. Ex. 38).

* * *

41. Mr. Seidman, a partner in the internationally known accounting firm of Seidman & Seidman testified that good will was a factor in the negotiations and that the five year average net worth of the business was $91,242.00, that the five year average net income of the business was $86,896.00 and that a fair return in investment was 10% which results in a good will evaluation or approximately $777,720.00 under the Respondent's own methods of evaluation. (R. 181a-192a, 190a-194a, 194a-198a, 198-199a, 248a-249a; Pet. Ex. 38, 39, 40)."

It was also simple arithmetic and undisputed fact based upon Exhibit JJ that the purchaser's intangible write-up of inventory and asset value of $409,593.52 and the covenant value of $375,000.00 **totaled $784,593.62 out of which only $82,109.74 was specifically allocated to trade routes or good will.** Obviously a substantial amount of the difference could have been found in the **Section 751 Code** unrealized appreciation adjustments to inventory required to be determined upon the sale of partnership interests under **Section 741 of the Code** and **this had been determined for the sellers and the Commissioner of Internal Revenue by Mr. Lemons, an examining agent for 21 years with the Internal Revenue Service** (R. 177a), **which made the evidence of this witness relevant and competent and material for decision of the case.**

It was the obligation of the trial court to determine the value of good will and to consider the totality of the facts of the case in order to realistically relate the value assigned to the covenant to the gains derived from the properties sold or to the personal characteristics or qualification of the sellers insofar as competition was concerned, rather than confine the facts of the case to the form of the transaction under its erroneous and obsolete "separate" and "severable" and "strong proof" standards.

Specific findings of the trial court as to the existence or nonexistence of good will and the value thereof based upon the totality of the facts of this case together with specific findings as to the relative values of the businesses sold and the personal qualifications of the covenantors, **would have been determinative of the taxable consequences of, and the economic reality of, the transaction.** It was for these reasons that the Petitioners called the Appellate Court's attention (p. 4, Pet. for Rehearing, Appendix, p. 7a) to the failure of the Respondent to comply with its Rule 16(4)(b) and **the Respondent's failure to provide a "counter statement of facts" pointing out insufficiencies or inaccuracies in the Petitioners' statement which included proposed findings of Nos. 26, 28, 32, 38 and 41, supra, based upon undisputed evidence.**

The significance of these determinative facts was that respondent's Exhibit JJ (R. 303a) showed that in June 1958 the purchaser had allocated (R. 220a, 229a-230a): $223,053.62 to assets, $240,000.00 to inventory, and $82,109.74 to trade routes or good will out of a total consideration of approximately $1,085,000.00; and that the purchaser **had considered the covenant nondeductible for income tax or a "capital" transaction.** In other words, intangible value of $240,000.00 was allocated to inventory, intangible value of $82,109.74 was allocated to trade routes of good will and the intangible

value of $375,000.00 which reposed in the covenant was considered as a nondeductible capital item for a total of $697,109.74 to intangibles. This was undisputed fact and simple arithmetic for the trial court.

Mr. Seidman's undisputed testimony showed the receipt of $549,646.81 out of a total of $709,019.15 received for tangible assets and $375,000.00 for the covenant out of a total consideration of $1,084,019.15. This established a material variation of $326,593.19 between the records of the Seller and the Purchaser.

The sellers' values, including an inventory value of approximately $20,000.00, had been the subject of a tax examination by the Commissioner of Internal Revenue's agent, Mr. Lemons, a witness subpoenaed by the Petitioners and present at the trial with his records.

It was also undisputed fact and simple arithmetic for the trial court that the purchaser had allocated $86,053.62 and $240,000.00, a significant total of $326,053.62 (indicating inconsistency by the commissioner), to new and used linen inventory, **a Section 751 of Internal Revenue Code of 1954** adjustment in sales of partnership interests required under **Section 741 of the Code**, another item involved in the tax examination conducted by the Commissioner's agent, Mr. Lemons. These items taken with the $82,109.74 allocated by the purchaser to trade routes amounted to $408,163.36, explaining the variance between the Sellers and the Purchasers records of the sale.

It was also simple arithmetic and undisputed fact that, using the Respondent's own methods for the evaluation of good will and a 10%, 15% or 20% return rate on investment, evaluations of $777,720.00 (10%), $518,490.00 (15%) and $388,860.00 (20%) resulted.

It was also simple arithmetic and undisputed fact (R. 89a) that Jt. Ex. 23-W contained a good will formula of 13 to 1 based upon sales volume of $60,000.00 per month **for the reduction** of the purchase price which could have resulted in reduction of as much as $780,000.00 in the purchase price.

The acceptance of the erroneous "separate," "severable" and "strong proof" tests by the Sixth Circuit has operated **to elevate form above substance and to eliminate a trial court's obligation to consider the totality of evidence in a tax case contrary to this Court's decisions in the** *Court Holding Company*, *Hansen* and *Duberstein* cases, supra. The erroneous concept of these enlightening cases adopted by the trial and appellate courts will result in whimsical diversities in the administration of tax law by the Commissioner and the trial courts in and among the Courts of Appeal for the Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth and Tenth Circuits and will result in the denial of substantial rights to tax litigants under *Rule 61, Fed. Rules of Civil Procedure.*

These very same erroneous "separate," "severable" and "strong proof" tests operated to deny Petitioners substantial rights under *Rule 61,* supra, not only insofar as their rights to have the totality of the facts considered under the *Duberstein* case, supra; but also, specifically, in the ruling of the trial court upon the offer of proof made by the Petitioners under *Rule 43, Fed. Rules of Civil Procedure.* In this manner: Petitioners placed under subpoena Mr. Lemons, the revenue agent of the Commissioner of Internal Revenue, who made the tax examination of the Petitioners' returns for the year in which the sale transaction occurred. Mr. Lemons had made inventory and other adjustments under *Sections 741 and 751 of the Internal Revenue Code of 1954* dealing with the sale of partnership interests.

The evidence of Mr. Lemons was competent and material and relevant to the issue of the existence or nonexistence and value of good will and to the value of tangible and intangible assets which was the subject of his examination as well as competent, material and relevant to the understanding of, and the substance underlying, the transaction of sale insofar as the Petitioners and the Commissioner had dealt with it in 1958.

The trial court rejected the offer of proof, sua sponte, compelling Petitioners' counsel to affirm the trial court's assertion that the testimony **was not binding upon the Court** as a matter of law (R. 178a) and that **the witness was not qualified to state an opinion as to a legal or factual judicial conclusion** (sic). (R. 179a). Later, when objection was raised by Petitioners' counsel (R. 214a-215a) to the Respondent's introduction of asset and inventory values which the Purchaser had allocated on its books as an indirect approach to an issue closed insofar as the Petitioners and the Respondent were concerned in 1958 by Mr. Lemons' examination, **the trial court called the purpose of the offer of proof "coloration".** (R. 214a-215a).

The seller had specifically disaffirmed and disavowed the purchaser's allocation of values. This was the undisputed proof of Mr. Seidman (R. 187a-188a) and it was admitted as true by the purchaser. (R. 220a). It was, therefore, relevant, material and competent to show the values which the Petitioners and Respondent had established in 1958 and agreed to and consistently adhered to by the Petitioners, through Mr. Lemons, the Respondent's own agent. It was testimony directly bearing upon the **substance underlying the transaction at a time when the legal standards and the facts were fresh in the minds of the Commissioner as well as in the minds of the Petitioners and the Purchaser.** Its materiality is emphasized when

Respondent's Exhibit JJ (R. 303a) is read, showing that the purchaser immediately after the transaction entered the covenant payments on its books **as nondeductible for income tax.** Mr. Lemons' testimony was also relevant and material to the determinative question of the existence or nonexistence of good will and the value thereof.

To justify this diminution by it of the totality of the facts of the case, the trial court relied upon the Second Circuit's *Ullman* case, supra, applying the "strong proof" rule against Petitioners, and has relied upon its "separate" and "severable" tests to support the form of the transaction over its substance.

This view of the trial court was an unwarranted extension of the rule of *Rogers* v. *United States,* supra, and has aborted the burden of proof rule in tax cases, resulting in a burden of proof street which is traveled one way by a taxpayer, but both ways by the Commissioner and the trial courts.

It was error for the trial court to reject Petitioners' offer of proof and it was error for the Court of Appeals for the Sixth Circuit to limit its review of the decision and the facts to the "separate" and "severable" standards now erroneous and obsolete under the *Court Holding Company, Hansen* and *Duberstein* cases, supra, holding (Op., p. 4a):

> "We find no error in the rulings of the Tax Court admitting or excluding evidence which deprived appellants of 'substantial rights,' Rule 61, Fed. R. Civ. P."

The rulings of the trial court including and excluding evidence diminished the record of determination facts and deprived the Petitioners of substantial rights. The continued application by trial and appellate courts of the obsolete and erroneous standards of "separate," "severable" and "strong proof" will continue to result in diversities

in the administration of the income tax law in and among the Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth and Tenth Circuits unless this Honorable Court exercises supervision and grants guidance to the courts.

CONCLUSION

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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